

**STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION**

<b>The Southern Company,</b>	)	
<b>AGL Resources, and</b>	)	
<b>Northern Illinois Gas Company</b>	)	
<b>d/b/a Nicor Gas Company</b>	)	<b>Docket No. 15-0558</b>
	)	
<b>Application for Approval of a Reorganization</b>	)	
<b>Pursuant to Section 7-204 of the Illinois</b>	)	
<b>Public Utilities Act</b>	)	

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**DIRECT TESTIMONY OF DAVID J. EFFRON  
ON BEHALF OF  
THE PEOPLE OF THE STATE OF ILLINOIS  
AND  
THE CITIZENS UTILITY BOARD**

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**AG/CUB Exhibit 1.0**

**FEBRUARY 3, 2016**

ICC DOCKET NO. 15-0558  
DIRECT TESTIMONY OF DAVID J. EFFRON  
AG/CUB EXHIBIT 1.0

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1    **I.        STATEMENT OF QUALIFICATIONS**

2    **Q.        Please state your name and business address.**

3    A.        My name is David J. Effron. My business address is 12 Pond Path, North Hampton, New  
4               Hampshire, 03862.

5

6    **Q.        What is your present occupation?**

7    A.        I am a consultant specializing in utility regulation.

8

9    **Q.        Please summarize your professional experience.**

10   A.        My professional career includes over twenty-five years as a regulatory consultant, two  
11               years as a supervisor of capital investment analysis and controls at Gulf & Western  
12               Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a  
13               Certified Public Accountant and I have served as an instructor in the business program at  
14               Western Connecticut State College.

15

16   **Q.        What experience do you have in the area of utility rate setting proceedings and**  
17               **other utility matters?**

18   A.        I have analyzed numerous electric, gas, telephone, and water filings in different  
19               jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in  
20               case preparation, and provided assistance during settlement negotiations with various  
21               utility companies.

22               I have testified in over two hundred cases before regulatory commissions in  
23               Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky,

1 Maine, Maryland, Massachusetts, Missouri, Nevada, New Jersey, New York, North  
2 Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia  
3 and Washington.

4  
5 **Q. Please describe your other work experience.**

6 A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was  
7 responsible for reports and analyses concerning capital spending programs, including  
8 project analysis, formulation of capital budgets, establishment of accounting procedures,  
9 monitoring capital spending and administration of the leasing program. At Touche Ross  
10 & Co., I was an associate consultant in management services for one year and a staff  
11 auditor for one year.

12  
13 **Q. Have you earned any distinctions as a Certified Public Accountant?**

14 A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores  
15 in the May 1974 certified public accounting examination in New York State.

16  
17 **Q. Please describe your educational background.**

18 A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and  
19 a Masters of Business Administration Degree from Columbia University.

20  
21 **II. INTRODUCTION**

22 **Q. On whose behalf are you testifying?**

1 A. I am testifying on behalf of the People of the State of Illinois as represented by the  
2 Illinois Attorney General (“AG”) and the Citizens Utility Board (“CUB”, together  
3 “AG/CUB”).  
4

5 **Q. What is the purpose of your testimony?**

6 A. The Southern Company, AGL Resources Inc. (“AGL Resources”), Nicor, Inc., and  
7 Northern Illinois Gas Company d/b/a Nicor Gas Company (“Nicor Gas” or “the  
8 Company”) (collectively the “Joint Applicants” or “JA”) are seeking approvals from the  
9 Illinois Commerce Commission (“the Commission” or “ICC”) to engage in certain  
10 transactions that will result in a reorganization of Nicor Gas. The proposed  
11 reorganization will result in AGL Resources (the parent of Nicor, Inc.) becoming a  
12 wholly-owned subsidiary of The Southern Company. Thus, there is a change of control,  
13 whereby The Southern Company will become the ultimate parent company of Nicor Gas.  
14 The purpose of my testimony is to address the allocation of any savings resulting from  
15 the proposed reorganization pursuant to Section 7-204(c) of the Illinois Public Utilities  
16 Act and conditions that the Commission may impose in approving the proposed  
17 reorganization to protect the interests of customers pursuant to Section 7-204(f) of the  
18 Public Utilities Act, 220 ILCS 5/7-204(f).  
19

20 **III. DESCRIPTION OF REORGANIZATION**

21 **Q. Please describe the proposed reorganization.**

22 A. The Southern Company will acquire all the outstanding shares of AGL Resources for  
23 \$66.00 cash per share. This represents a transaction premium of about 36% compared

1 to the price of the AGL Resources common stock prior to the announcement of the  
2 proposed merger on August 24, 2015. After the reorganization is completed, Nicor Gas  
3 will become an indirect subsidiary of The Southern Company.  
4

5 **IV. ALLOCATION OF SAVINGS**

6 **Q. Have the Joint Applicants identified any synergies or savings that will result from**  
7 **the merger and reorganization?**

8 A. No. The Joint Applicants “have not identified any immediate net savings to AGL  
9 Resources/Nicor Gas from the Reorganization” because “the structure of the merged  
10 companies will maintain the existing core management team of AGL Resources and  
11 Nicor Gas,” and the Joint Applicants “do not anticipate any material changes to the  
12 manner in which Nicor Gas provides service to its customers.” JA Ex. 1.0, at 21:468-  
13 473.  
14

15 **Q. Does this mean that no savings at all will result from the merger and**  
16 **reorganization?**

17 A. No. In explaining why there is nothing to be addressed with respect to the Section 7-  
18 204(c) requirement that the Commission must rule on the allocation of any savings  
19 resulting from the proposed reorganization, the Joint Applicants state that “any savings  
20 allocable to Nicor Gas resulting from the Reorganization will be passed through to  
21 customers in the normal course of the ratemaking process.” JA Ex. 1.0, at 22:476-478.  
22 In addition, the Joint Applicants state that they “expect the future integration of SCS  
23 [Southern Company Services] and AGSC [AGL Services Company] to provide

1 additional efficiencies as systems and services are consolidated and best practices are  
2 implemented.” JA Ex. 3.0, at 5:100-101. Thus, the Joint Applicants clearly recognize  
3 the potential for synergies and savings even though they have not offered a  
4 quantification of any particular savings resulting from the merger in conjunction with  
5 their application in this docket.

6

7 **Q. Do you agree that any savings allocable to Nicor Gas resulting from the**  
8 **Reorganization will automatically be passed through to customers in the normal**  
9 **course of the ratemaking process, as the Joint Applicants imply?**

10 A. No. As I explain below, based on my analysis, Nicor Gas has earned a return on equity  
11 in excess of its authorized return in recent periods. Therefore, as long as these excess  
12 earnings continue, The Southern Company will be able to retain future merger savings  
13 allocable to Nicor Gas for its shareholders, denying the benefits of such savings to  
14 customers.

15

16 **Q. How does the Reorganization relate to the level of excess earnings presently being**  
17 **experienced by Nicor Gas in these circumstances?**

18 A. To the extent that the merger does result in any future synergies and/or economies of  
19 scale, those savings will decrease costs incurred by Nicor Gas and increase the excess of  
20 revenues over costs, thereby augmenting the Company’s excess earnings. Indeed, even if  
21 the Reorganization does not result in any reductions to expenses but only enables the  
22 Company to avoid expense increases that would otherwise take place, the Reorganization  
23 will likely have the effect of perpetuating the Company’s excess earnings. As long as the

1 Company continues to experience excess earnings, when future merger savings allocable  
2 to Nicor Gas are realized, those savings will not be passed through to the Company's  
3 customers, but rather will be retained by the Company's ultimate shareholders  
4 subsequent to the Reorganization. Thus, the Reorganization has the potential to  
5 perpetuate and enhance the Company's excess earnings. As I explain below, this is  
6 especially problematic from the perspective of customers, given the origin of those  
7 excess earnings.

8

9 **Q. Can you summarize the analysis that leads you to conclude that Nicor Gas has been**  
10 **earning a return on equity in excess of its authorized return?**

11 A. Yes. In 2014, the Company's net income was \$100.0 million. This translates into a  
12 return on equity of 14.70% on an average balance of equity of \$680.5 million in 2014.  
13 The authorized return on equity from the Commission's final order in Docket No. 08-  
14 0363, dated March 25, 2009, is 10.17%. Thus, the Company's earned return on equity in  
15 2014 exceeded its authorized return on equity by 4.53 percentage points. This equates to  
16 excess net income of \$30.8 million, which translates into excess revenues of \$52.2  
17 million (Schedule DJE-1, attached as AG/CUB Exhibit 1.1).

18

19 **Q. To what do you attribute these excess earnings?**

20 A. In October 2013, in Docket No. 13-0500, the Commission, pursuant to Section 5-104(e)  
21 of the Public Utilities Act, approved changes in the Company's depreciation accrual rate  
22 that had the effect of reducing the composite depreciation rate from 4.10% to 3.07%.  
23 Those changes were effective as of the end of August 2013. This change in depreciation



1 rates had the effect of reducing the 2014 depreciation expense by \$51 million. Absent  
2 this reduction to the 2014 depreciation expense, the Company's earned return on equity  
3 would have approximated the return on equity authorized by the Commission in Docket  
4 No. 08-0363.

5 It should be noted that this reduction to the Company's depreciation accrual rates  
6 took place when Nicor Gas was under a rate freeze, pursuant to the terms of the merger  
7 approval in Docket No. 11-0046. A reduction to a utility's depreciation rates in the  
8 context of a rate freeze reduces the depreciation expense being recorded by the utility;  
9 but this is of no benefit to customers because the service rates being charged by the  
10 utility are not affected by the lower depreciation expense.

11

12 **Q. Does the reduction to depreciation expense have consequences other than the**  
13 **increases to the Company's income?**

14 **A.** Yes. When depreciation expense is recorded, the offsetting entry is to the accumulated  
15 reserve for depreciation, which includes the cumulative balance of charges to  
16 depreciation expense. Thus, the reduction to depreciation expense also results in the  
17 depreciation reserve being lower than it would be otherwise. The depreciation reserve  
18 is deducted from the gross plant in service in the determination of the net plant in  
19 service that is included in the Company's rate base in the context of base rate cases.  
20 With the reduction in depreciation expense, the credits to the depreciation reserve are  
21 less than the depreciation presently being recovered in the rates being charged to  
22 customers.

1           At the time of the first rate case subsequent to the end of the rate freeze, the  
2           depreciation reserve is lower because of the reduced depreciation expense. As the  
3           depreciation reserve serves as a rate base deduction, this means that the rate base will  
4           be higher, which in turn means that the utility's revenue requirement, and ultimately the  
5           rates paid by customers, will be higher. In these circumstances, the customers end up  
6           paying for the excess returns being earned by the Company with higher rates in the  
7           future.

8           While excess earnings by a regulated public utility should always be a matter of  
9           concern, I believe that when those earnings emanate entirely from a reduction to  
10          depreciation rates between rate cases, the problem is of even greater concern, in that the  
11          excess earnings in these circumstances result from changes that translate directly into  
12          higher future rates to customers. The longer the excess earnings related to the  
13          depreciation expense reduction continue, the greater the cumulative effect on the  
14          depreciation reserve and rate base, and the greater the effect on the future rates charged to  
15          customers.

16  
17   **Q.    Do you expect that it is likely that the excess earnings experienced by Nicor Gas in**  
18   **2014 will continue?**

19   **A.**    Yes. First, the income earned by Nicor has been relatively stable, exclusive of the effect  
20          of the changes in the depreciation accrual rates. For example, in 2013, the Company's  
21          net income was \$81.7 million, approximately \$18.3 million less than the net income in  
22          2014. But this difference is directly attributable to the fact that the reduction to the  
23          depreciation rates was in effect for only part of 2013. If the lower depreciation rates had

1        been in effect for all of 2013, the Company's net income for that year would have been  
2        about the same as it was in 2014.

3                Going forward, I would expect that the most significant factor causing changes in  
4        the Company's net income would be changes in operation and maintenance expense.  
5        The response to Staff Data Request MEM 1.06, Exhibit 1 shows that the Company  
6        expects that the O&M expense, other than those expenses subject to recovery through  
7        riders, will be slightly less in 2015 (based on nine months of actual expenses and three  
8        months of forecasted expenses) than the level of those expenses in 2014. The response to  
9        Staff Data Request MEM 1.04, Exhibit 1 shows the forecasted O&M expenses (again,  
10       other than those expense subject to recovery through riders) for 2016 to increase slightly  
11       from 2015, to about the same level as in 2014. There are increases in O&M forecasted  
12       for 2017 and 2018, but not to the extent that the excess earnings would cease.

13  
14    **Q.    Do you have a recommendation?**

15    A.    Yes. It is my understanding, based on advice of counsel, that under Section 7-204(f) of  
16       the Public Utilities Act, in approving any proposed reorganization pursuant to Section 7-  
17       204, the Commission may impose such terms, conditions or requirements as, in its  
18       judgment, are necessary to protect the interests of the public utility and its customers. I  
19       am further advised that under Section 9-202(a) of the Public Utilities Act, the  
20       Commission has authority to order temporary reductions to the a utility company's rates  
21       that would absorb any excess earnings to the extent necessary to provide a reasonable rate  
22       of return and then open an investigation to determine whether such temporary reductions  
23       should be made permanent.

1 I recommend that the Commission order a temporary reduction to the Company's  
2 rates to reduce its base rate revenues by \$52 million as a condition of merger approval.  
3 This rate reduction is necessary to protect the interests of the Company's customers by  
4 holding them harmless prospectively from the increased rates related to the diminished  
5 future depreciation reserve resulting from the reduced depreciation rates implemented in  
6 2013. The Commission should then investigate the extent to which the revenues  
7 produced by present rates will exceed the Company's post-merger cost of service and  
8 whether the permanent rates presently in effect should be reduced accordingly.

9

10 **Q. Does this conclude your direct testimony?**

11 **A. Yes.**